Regulating Housing GSEs: Thoughts on Institutional Structure and Authorities

W. Scott Frame*
Research Department
Federal Reserve Bank of Atlanta
1000 Peachtree Street NE
Atlanta GA 30309
Tel: 404-498-8783
Fax: 404-498-8810
e-mail: scott.frame@atl.frb.org

Lawrence J. White*
Stern School of Business
New York University
44 West 4th Street
New York, NY 10012-1126
Tel: 212-998-0880
Fax: 212-995-4218
e-mail: lwhite@stern.nyu.edu

Abstract

The appropriate regulatory structure for the three housing government-sponsored enterprises (GSEs) raises interesting issues of political economy, as well as being an active concern for the Congress and the Bush Administration. In this paper, we review recent events, including several legislative proposals aimed at altering the institutional structure and authorities of housing GSE oversight. We then outline the relevant issues and offer some opinions about what we view as the appropriate institutional structure and authorities of GSE regulation.

JEL Classification Numbers: G21, G28

Keywords: Government-sponsored enterprises, risk, regulation

*The views expressed in this paper do not necessarily reflect those of the Federal Reserve Bank of Atlanta, the Federal Reserve System, or their staffs. During 1986-1989 White was a member of the Federal Home Loan Bank Board and hence was also a board member of Freddie Mac and oversaw the Federal Home Loan Bank System. We would like to thank Michael Fratantoni and Edward Golding for their helpful comments on an earlier draft.

Regulating Housing GSEs: Thoughts on Institutional Structure and Authorities

I. Introduction

Three government-sponsored enterprises (GSEs) play a significant role in U.S. housing markets: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLB System). Congress created each of these entities; and their federal charters include numerous provisions that result in lower operating and funding costs.[1] The primary public contribution of these entities is to use their federal benefits to reduce mortgage interest rates faced by homebuyers with "conforming" mortgages.[2] The U.S. Congressional Budget Office (CBO) (2001) estimates that, for 2000, the gross benefits accruing to the housing GSEs were $13.6 billion, the net benefit to homebuyers was $7.0 billion, and the residual benefit to GSE equity holders was $6.6 billion.[3]

---

[1] See, for example, U.S. Congressional Budget Office (2001, 13-14) for a discussion of the various benefits afforded the three housing GSEs. The charter acts for these institutions can be found at: 12 U.S.C. §§ 1716 *et seq*. (Fannie Mae), 12 U.S.C. §§ 1451 *et seq*. (Freddie Mac), and 12 U.S.C. §§ 1421 *et seq*. (Federal Home Loan Banks).

[2] Conforming mortgages are those with balances below the legal limits on the size of mortgages that Fannie Mae and Freddie Mac can buy. For single-family mortgage loans, the conforming loan limit was $300,700 in 2002 and $322,700 in 2003 and is $333,700 in 2004. During 2002, there were $1.9 trillion in single-family conforming mortgage originations.

The FHLB System was established in 1932 to provide low-cost finance to thrift institutions, who were primarily engaged in originating (and holding) residential mortgages and who were expected to pass on the their lower costs of finance in lower interest rates on those mortgages. Since the enactment of the Financial Institutions Reform, recovery, and Enforcement Act (FIRREA) of 1989 and the Gramm-Leach-Bliley Act (GLBA) of 1999, the FHLB System's membership has been widened to encompass commercial banks, and its mission has been widened to encourage other kinds of loans in addition to residential mortgages.

[3] See Fannie Mae (2001), Freddie Mac (2001), Toevs (2001), and Pearce and Miller (2001) for various criticisms of this CBO study.

The three housing GSEs grew rapidly over the past decade and are now enormous financial institutions; they constitute three of the five largest financial institutions in the U.S. [4] As of year-end 2002, they held or guaranteed over *$4.1 trillion* in primarily mortgage-related assets. The three housing GSEs are also highly leveraged: They hold about $88.2 billion in equity capital against $2.4 trillion in assets and $1.7 trillion in off-balance-sheet mortgage credit guarantees.[5] To finance their portfolios and manage the attendant market risks, the housing GSEs issue significant quantities of debt and are major participants in over-the-counter derivatives markets. Arguably, an important reason for why the housing GSEs have achieved their scale and can operate in such a leveraged manner is that their obligations (debt and mortgage-backed securities) benefit from an *implied* federal guarantee arising from their charter benefits and from past government actions.[6] In essence, these enterprises are able to borrow at interest rates that are more favorable than those of AAA-rated corporate borrowers (though not quite as favorable as the interest rates at which the U.S. Treasury can borrow),[7] even though their stand-alone ratings (absent the implied guarantee) would otherwise be in the A to AA range.[8]

---

[4] As of year-end 2002, the five largest U.S. companies (ranked by total on-balance-sheet assets) were: 1) CitiGroup, 2) Fannie Mae, 3) JPMorgan Chase, 4) FHLB System, and 5) Freddie Mac.

[5] This corresponds to an aggregate capital-to-assets ratio of 3.7 percent.

[6] By law, GSE securities are required to include language indicating that they are not guaranteed by, or otherwise an obligation of, the federal government. However, past government actions suggest otherwise. During the late 1970s and early 1980s, Fannie Mae was insolvent on a market value basis and benefited from supervisory forbearance. Also, in the late 1980s, the Farm Credit System (another GSE) required a taxpayer bailout totaling $4 billion. The U.S. General Accounting Office (1990, 90–91) discusses both of these episodes, while Kane and Foster (1986) provide estimates of the degree of insolvency for Fannie Mae during its financial distress.

[7] Indeed, the financial reporting of the yields on GSE obligations usually refers to them as “government agency” issues.

[8] Fannie Mae and Freddie Mac do receive AA- ratings from Standard and Poor’s in terms of their risk to the government. However, such ratings incorporate whatever government support or intervention the entity typically enjoys during the normal course of business.

In sum, the housing GSEs are very large, highly leveraged financial institutions that the capital markets believe benefit from an implied federal guaranty. To the extent that the capital markets are correct in this belief,[9] taxpayer risk should appropriately be limited by a federal regulatory structure that is designed to maintain the safety and soundness (i.e., solvency) of these institutions in a manner analogous to that for federally insured depository institutions.[10]

The current regulatory structure for the housing GSEs has been in place for just over a decade. The Office of Federal Housing Enterprise Oversight (OFHEO) is the safety and soundness regulator for Fannie Mae and Freddie Mac, while the U.S. Department of Housing and Urban Development (HUD) is their mission regulator.[11] The Federal Housing Finance Board (Finance Board) exclusively regulates the FHLB System.[12] All three regulators (OFHEO, HUD, and the Finance Board) have endured persistent criticism for a perceived lack of effectiveness.[13] Recent financial and accounting revelations at Fannie Mae and Freddie Mac have thus quickly led to renewed calls for a new and stronger regulator for housing GSEs.

[9] It is worth noting that, though the senior officials of the U.S. Treasury have (at various times) called attention to the disclaimer on the GSE securities and described "the market misperception of an implied guarantee" (Snow 2003b), they have never explicitly and unequivocally said that they would adhere to that disclaimer, nor has any presidential administration advocated the repeal of the GSEs' special privileges.

[10] We hasten to add that "analogous" need not mean "the same as". Also, the presence of a federal safety-and-soundness regulatory regime could serve to strengthen the financial markets' perception of an implied guarantee.

[11] The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established OFHEO. Prior to this, HUD maintained exclusive regulatory oversight responsibilities for Fannie Mae. Prior to the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, Freddie Mac was the responsibility of the Federal Home Loan Bank Board (FHLBB). Between 1989 and 1992, responsibility for overseeing Freddie Mac lay with HUD.

[12] Prior to the passage of the FIRREA in 1989, supervision and regulation of the FHLB System was the responsibility of the FHLBB. The FHLB System is less prominent than are Fannie Mae and Freddie Mac; for more information about the FHLBs, see Frame (2003) and Craig and Thomson (2003).

[13] Two episodes exemplifying this were related to: 1) the length of time (10 years) it took for OFHEO to finalize its risk-based capital regulation for Fannie Mae and Freddie Mac, and 2) HUD's and the Finance Board's failure to propose regulatory limits on non-mortgage investments made by the housing GSEs. See also General Accounting Office (1997b, 1998a, 1998b) for evaluations of the regulatory effectiveness of OFHEO, Finance Board, and HUD, respectively. More recently, in testimony before the House Financial Services Committee on September 10, 2003,

This paper summarizes the 2003 legislative debate over housing GSE oversight and then outlines and evaluates changes to the regulatory structure proposed by various policymakers. We begin by reviewing the events triggering the most recent round of legislative discussion.

II. Recent Events

Two recent events spurred Congress to consider seriously whether changes should be made to the oversight of the housing GSEs. The first was a disclosure by Fannie Mae that suggested that the enterprise had a significant exposure to interest rate movements. The second was the uncovering of accounting misstatements at Freddie Mac that resulted in the departure of several top executives from the institution.

Fannie Mae's Duration Gap. In October 2000, Fannie Mae and Freddie Mac announced six voluntary initiatives intended to enhance their market discipline, increase liquidity, and improve transparency.[14] In terms of disclosures, the two GSEs subsequently began reporting certain interest rate risk measures on a monthly basis, including their *duration gap*, or the difference between the weighted-average durations of their assets and their liabilities.[15]

Treasury Secretary John Snow remarked that there is a "general recognition that the supervisory system for the housing GSEs neither has the tools, nor the stature, to effectively deal with the current size, complexity, and importance of these enterprises."

[14] General information about the initiatives can be found on Fannie Mae's web-site at www.fanniemae.com, including a seventh initiative announced in 2002 (mandatory Securities and Exchange Commission disclosures). See also Frame and Wall (2002) for an analysis of the original six initiatives in the context of current thought and practice from the banking industry. Though the initiatives were "voluntary" (in the sense that they were not mandated by law or regulation), they were clearly undertaken in the hopes (which so far have been realized) of forestalling legislation that would mandate these same actions and that would probably mandate other things as well.

[15] While duration gap is a commonly used measure of the exposure of a portfolio to changes in interest rates, it is not well suited for measuring changes in portfolio value that are due to large interest rate movements, nor does it necessarily provide a good measure of risk for a portfolio with many embedded options, such as those associated with mortgage prepayments. See Cohen (1993) and Saunders (2000) for detailed discussions of the limitations of duration gap.

Table 1 reports the duration gap estimates for Fannie Mae and Freddie Mac since mid-2001.[16] Note that between July and September 2002, Fannie Mae's reported duration gap was –9 months, –14 months, and –10 months, respectively, reflecting a considerable shortening in the effective duration of their assets. Media reports during this time suggest that this was due to unprecedented refinancing activity spurred by declining long-term interest rates. For all three months, Fannie Mae's duration gap fell outside of its target range of +/- 6 months[17] and suggested a considerable exposure to future interest rate movements.[18] Indeed, according to Shadow Financial Regulatory Committee (2002), given Fannie Mae's leverage position, a duration gap of –14 months would have implied that a one-percentage point decline in interest rates could result in a 40 percent decline in its capital.[19] To reduce its duration gap, Fannie Mae relied on growth and hedging – i.e., a combination of mortgage commitments, mortgage purchases, hedging with swaps and swaptions, and callable debt issues (Haviv 2002).

Following the September 2002 duration gap announcement, OFHEO reportedly sent a letter to Representatives Richard Baker and Paul Kanjorski indicating that it had increased its oversight of Fannie Mae's mortgage portfolio and duration gap (Canfield & Associates, Inc., 2002a). To that

---

See also Jaffee (2003) for a detailed discussion of interest rate risk and its management at Fannie Mae and Freddie Mac.

[16] These estimates are available from each institution's web-site (www.fanniemae.com and www.freddiemac.com). Duration gap information for Fannie Mae is available since March 2001, while for Freddie Mac it is not available prior to August 2001.

[17] See Fannie Mae's news release (March 26, 2001) announcing implementation of the voluntary initiatives, including the target range of +/- 6 months, at: www.fanniemae.com/newsreleases/2001/1209.jhtml?p=Media&s=News+Releases.

[18] Indeed, since the disclosures began, Fannie Mae has found itself outside of its target range in 6 of the 31 months. Fannie Mae (2002a) notes that, over longer horizons, its duration gap falls within its target range only about 2/3 of the time. Freddie Mac, by contrast, has yet to report a duration gap outside of +/- 1 month. However, the duration gaps for Fannie Mae and Freddie Mac are not directly comparable, since the two GSEs compute their duration gaps somewhat differently.

[19] The statement also noted that it is possible that more complicated measures of interest rate risk exposure would imply a lesser exposure to loss.

end, OFHEO required an action plan to correct the imbalance and to monitor Fannie Mae's maintenance of its duration gap for the following six months, or until April 2003. In a September 2002 letter, Representative Baker reportedly then criticized OFHEO for not addressing Fannie's growing risk sooner: "OFHEO's recognition of Fannie Mae's problem is overdue and your delaying allowed unacceptable levels of risk to continue for far too long" (Canfield & Associates, Inc., 2002b).[20]

Freddie Mac's Accounting Irregularities. In January 2003, Freddie Mac announced that it would restate its earnings for the previous three years and that these restated earnings would be materially higher, after its new auditor[21] recommended certain changes to the enterprise's accounting policies. The restatement was originally characterized as a simple disagreement about the application of Generally Accepted Accounting Principles (GAAP) focusing primarily on: 1) how to value certain derivative transactions; and 2) the classification of mortgage assets between available-for-sale and trading accounts via certain resecuritization transactions. This perception was altered, however, when in June 2003 Freddie Mac announced that its three top executives had left the company.[22] Furthermore, a July 2003 report commissioned by Freddie Mac's board of directors found that management had "… encouraged the use of complex, capital-market transactions and, to a lesser extent, reserve adjustments, for purposes of achieving strong, steady

---

[20] Representative Baker reportedly also noted in the letter that he had originally made his concerns known about Fannie Mae's duration gap in December 2001 following an announcement that the gap was –10 months.

[21] PricewaterhouseCoopers had replaced Arthur Andersen as Freddie Mac's auditor in March 2002.

[22] These were: David Glenn (President), Leland Brendsel (Chief Executive Officer and Chairman), and Vaughn Clarke (Chief Financial Officer). Reportedly, Glenn was fired for failing to cooperate with an internal investigation of the enterprise's accounting, while Brendsel and Clarke resigned. Freddie Mac replaced Brendsel with Gregory Parseghian, who was relieved in August 2003 but continued in the position until Richard Syron was named as his successor in December 2003.

earnings growth …" (Baker-Botts L.L.P., 2003, p. 5).[23] Simply put, the report suggests that Freddie Mac engaged in earnings management. The accounting restatement, released in November 2003, resulted in an upward adjustment in cumulative earnings through year-end 2002 of $5.0 billion.[24]

Following the June 2003 management shake-up, OFHEO Director Armando Falcon sent a letter to Freddie Mac's Board of Directors outlining actions – beyond the personnel changes -- required of the board related to the enterprise's restatement process.[25] The letter also indicated that OFHEO dispatched a special investigation team to Freddie Mac to look at the restatement process, management's progress in implementing the action plan, and employee misconduct.[26] This investigation culminated in a December 2003 report by OFHEO that included sixteen recommended actions for Freddie Mac and OFHEO to take and imposed a $125 million fine on the company.[27]

In the wake of the accounting travails at Freddie Mac are a number of federal investigations and class-action lawsuits, which are summarized in Freddie Mac (2003). The investigations include inquiries from: OFHEO, the Internal Revenue Service (IRS), the Securities and Exchange Commission (SEC), the U.S. Attorney's Office (Eastern District of Virginia), and the U.S. Department of Labor. Class action lawsuits, which allege violations of

---

[23] Baker-Botts L.L.P. (2003) details each of the groups of transactions originally in question and evaluates the extent to which they complied with GAAP and, if not, who was responsible for their undertaking and improper accounting treatment.

[24] This cumulative increase was the product of the following changes: $4.3 billion in 2002, -$1.0 billion in 2001, $1.1 billion in 2000, and $0.6 billion for pre-2000 reporting years. See www.freddiemac.com/news/archives/investors/2003/restatement_112103.html.

[25] This letter is available at: www.ofheo.gov/media/pdf/OFHEOLETTER67031.pdf.

[26] OFHEO has also begun a review of Fannie Mae's accounting practices as well. Indeed, shortly after announcing this review, Fannie Mae disclosed an accounting error totaling $1.2 billion.

[27] This report is available at: www.ofheo.gov/media/pdf/specialreport122003.pdf.

federal securities laws and regulations, have been brought by (among others) the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio.

III. Legislative Response

Following the accounting problems at Freddie Mac, several members of Congress responded by introducing bills aimed at strengthening the current supervisory and regulatory framework for Fannie Mae and Freddie Mac: H.R. 2575 (Representative Baker), H.R. 2803 (Representative Royce), S. 1508 (Senators Hagel, Sanunu, and Dole), and S. 1656 (Senator Corzine).[28] While the approaches to regulatory reform vary somewhat, all of the legislative proposals would:

- Abolish OFHEO and create a new regulator in the Department of the Treasury;
- Increase the budget autonomy of the new regulator;
- Transfer some oversight responsibilities from HUD to the new regulator;
- Increase regulatory discretion in setting certain capital standards; and
- Enhance enforcement authorities.

Nott and Jickling (2003) include a detailed side-by-side comparison of each bill's provisions.

Treasury Secretary John Snow first presented the Bush Administration's views on GSE regulatory reform in testimony before the House Financial Services Committee on September 10,

[28] There was also a House Financial Services Committee manager's amendment to H.R. 2575 released in preparation for an October 8, 2003, mark-up that was subsequently canceled. Three related bills were introduced in 2003 that would remove certain statutory benefits afforded Fannie Mae and Freddie Mac. First, H.R. 2022 (Representatives Shays and Markey) would repeal the enterprises' exemption from registering their securities with the SEC. Second, H.R. 2117 (Representative Pete Stark) would eliminate Fannie Mae's and Freddie Mac's statutory exemption from state and local income taxes. Finally, H.R. 3071 (Representative Ron Paul) would repeal several aspects of all three housing GSEs' charters: 1) the state and local income tax exemption; 2) the President's authority to appoint directors to these GSEs' boards of directors; 3) the Secretary of the Treasury's authority to approve GSE debt issues 4) the discretionary authority of the Secretary of the Treasury to purchase GSE obligations; and 5) certain other provisions that confer favorable investment status on GSE securities.

2003 (Snow 2003a). In it, Secretary Snow stated that the new agency's powers should be "comparable in scope and force to those of other world-class financial supervisors," and he offered several recommended changes to the structure and powers to the safety and soundness regulator for Fannie Mae and Freddie Mac. [29] These included: 1) locating the new regulatory agency within the Treasury (under certain conditions); 2) funding the agency by assessments that are outside of the appropriations process; 3) giving the agency prior approval over new activities; 4) providing the agency with the authority to direct, if necessary, the liquidation of an enterprise's assets (i.e., receivership authority);[30] and 5) giving the agency discretionary powers to adjust risk-based capital standards.

In October 16, 2003, testimony before the Senate Banking Committee, Secretary Snow (2003b) reiterated his earlier suggested changes, clarified the terms under which the Bush Administration would support moving housing GSE oversight to the Treasury Department, and offered additional changes. He noted that Treasury would accept responsibility for the new safety and soundness agency if it had "adequate elements of policy accountability" to Treasury, including: clearing regulations, clearing testimony for policy consistency, and reviewing the annual budget.[31] Secretary Snow also stated that the new regulator should have the authority to review and modify <u>both</u> minimum and risk-based capital requirements, as well as having well-defined receivership

[29] Testimony at the same hearing from HUD Secretary Mel Martinez also made clear that the Bush Administration supports HUD's continued involvement in GSE mission oversight, particularly with respect to affordable housing goals. In his testimony, Secretary Martinez outlined a number of suggested changes to mission oversight: 1) creating a new GSE Housing Office within HUD that is independently funded by the GSEs to establish, maintain, and enforce the housing goals; 2) granting to HUD new administrative authority to enforce its housing goals; 3) instituting enhanced civil money penalties for failure to meet housing goals; 4) explicitly providing that the GSEs act to increase homeownership; and 5) expanding HUD's authority to set housing goals and subgoals beyond the three currently established for moderate-income, geographic area, and special affordable housing. This testimony is available at: http://financialservices.house.gov/media/pdf/091003mm.pdf.

[30] Secretary Snow added, however, that rescinding a GSE charter would still require an act of Congress.

[31] Secretary Snow also added that the new agency should have independent responsibility over specific matters of supervision, enforcement, and access to Federal courts.

authorities. His testimony also offered support for moving FHLB oversight into this new regulatory authority. In his testimony, Secretary Snow emphasized that he was not "presenting a wish list of reforms that we would like to see enacted, but rather the minimum elements that are needed in a credible regulatory structure."[32]

On September 25, 2003, representatives of both Fannie Mae and Freddie Mac testified before the House Financial Services Committee (hereafter Raines (2003) and Gould (2003), respectively). Both enterprises offered their general support for legislative efforts modeled on the Administration's proposal, including the creation of a new safety and soundness regulator in Treasury with a stable funding base (i.e., outside of the appropriations process) and with the ability to adjust risk-based capital formulas. Raines (2003) and Gould (2003) did, however, express concerns about which regulator would have new program approval, the scope of these new program approval authorities, and the possibility of the new regulator's having receivership authority.

Despite what appeared to be a broad consensus on GSE regulatory reform, efforts quickly stalled. A legislative mark-up scheduled for October 8, 2003, in the House of Representatives was halted because the Bush Administration withdrew its support for the bill, although Representative Baker laid the blame for the derailment of reform on Fannie Mae and Freddie Mac (Inside Mortgage Finance, 2003). No further legislative activity occurred in 2003.

IV. Enhancing GSE Oversight, Safety, and Soundness

This section evaluates the key changes to housing GSE oversight suggested by members of Congress, the Bush Administration, and the enterprises themselves. To that end, we generally focus

[32] N. Gregory Mankiw, Chairman of the Council of Economic Advisors, also publicly provided the Bush Administration's views in a speech delivered on November 6, 2003 (Mankiw 2003). In it, Mr. Mankiw argued that the new safety and soundness regulator should have a permanent funding mechanism, the authority to set both risk-based and minimum capital standards, the authority to reject new GSE activities, and receivership powers.

on intent, rather than the specific wording in proposed legislation that may/may not result in expected changes. Moreover, while each of the legislative proposals contains a myriad of provisions, we look at those likely to result in a significant change to regulating the housing GSEs.

The regulatory changes may be broadly delineated as either pertaining to institutional design (e.g., where the regulator is located, how the regulator is funded) or institutional authorities (e.g., discretion to alter capital requirements, ability to appoint conservators and receivers). In terms of institutional design, our analysis draws on previous discussion by the U.S. General Accounting Office (GAO) (1997a), while GAO (2001) provides a detailed comparison of institutional authorities for federal banking regulators, OFHEO, and the Finance Board. Carnell (2003) also examines all of the issues described below.

A. Institutional Design

The broad points of discussion in the legislative debate concerning institutional design of a new safety and soundness regulator for the housing GSEs have been about three related issues: 1) the location of this regulator, 2) the funding mechanism for the regulator, and 3) who the regulator should supervise. Currently, OFHEO is an "independent" agency that is located within HUD.[33] It is headed by a presidentially appointed director (who serves a fixed term of office) and is funded by assessments collected from Fannie Mae and Freddie Mac, subject to the congressional appropriations process. HUD has approval authority over new programs as part of its mission

---

[33] The designation as an independent agency usually implies that the organization's senior leadership is appointed by the President, confirmed by the senate, and serve fixed terms of office (rather than serving at the pleasure of the President, as is true of "normal" executive branch senior positions). Also, independent agencies (such as the Federal Trade Commission or the Federal Reserve) are often located outside of executive branch departments (and thus are not subject to the general oversight of the secretary of a department). The current structure of the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and OFHEO represent hybrids between independent agencies and full executive branch structures, in that they are located within executive branch departments (and thus subject to the general oversight of their respective department secretaries) but their leaders serve fixed terms of office (and they do not have to clear congressional testimony or regulations with their departmental secretaries).

oversight responsibilities, while OFHEO reviews these applications to identify any safety and soundness issues. The Finance Board is an independent agency that is located outside the executive branch. Five board members, including a representative from HUD and four presidentially appointed directors, head the agency. The Finance Board has mission as well as safety-and-soundness responsibilities for the FHLBs.

1. **Location of the GSE Regulator**.

All of the legislative proposals in 2003 involved abolishing OFHEO and replacing it with a new office housed within the Department of the Treasury. In our opinion, Treasury is the logical cabinet department for a new housing GSE safety and soundness regulator to reside, because of Treasury's prominence within the executive branch and its financial expertise. Indeed, the only other logical cabinet choice would be HUD – with its housing expertise and where OFHEO is located today – but there appears to be broad consensus that this arrangement is not functioning as intended. The extent to which this is related to HUD's housing advocacy, OFHEO's funding and supervisory constraints, or the political dynamic of regulating only two firms (that are very large and politically active) is an open question.

The desire to move safety and soundness regulation for housing GSEs to Treasury, however, became quite contentious in 2003 after the Bush Administration insisted that the legislation include provisions that would make the proposed bureau less "independent" than the other two financial regulatory bureaus currently housed in Treasury: the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). Specifically, the Administration would like the new agency to clear regulations and congressional testimony through Treasury. According to Snow (2003b), Treasury's direct involvement in policy guidance is important for two reasons. First, unlike the other Treasury bureaus, the new agency would be responsible for only a handful of very large financial institutions, which thereby increases the possibility of regulatory capture. Second, each of the housing GSEs benefit from an implied federal guarantee, which reduces market discipline; and for this reason, Treasury feels that it needs the power to monitor the new regulator's policies so that they are not "reinforcing any such market misperception of an implied guarantee." That said, Snow also highlighted the importance of protecting the independence of the agency over specific matters of supervision, enforcement, and access to federal courts.

Not surprisingly, some policymakers – especially in the Congress -- are wary of Treasury's position and believe that the new GSE regulator should be as independent as the OCC and OTS. For example, at a September 25, 2003, hearing, Representative Carolyn Maloney's written statement noted that "without the ability to take independent positions before Congress, the authority of the new regulator will constantly be in question and different parties will attempt to influence regulatory outcomes by appealing to higher levels in the Treasury Department."[34] At the same hearing, OFHEO director Armando Falcon's written testimony stated that regulators "should be objective, nonpartisan, and protected from political interference;" and that "this is especially critical when regulators must make difficult and sometimes politically unpopular decisions."[35]

An alternative to placing housing GSE oversight in a cabinet department would be to locate it in an independent agency outside of the executive branch. This would be consistent with the recommendation of GAO (1997a), which concluded that there should be a single, "stand-alone" housing GSE regulator for Fannie Mae, Freddie Mac, and the FHLBs that spans both mission

[34] This statement is available at: http://financialservices.house.gov/media/pdf/092503ma.pdf

[35] This testimony is available at: http://financialservices.house.gov/media/pdf/092503af.pdf

and safety and soundness responsibilities. This could be newly established agency or made part of an existing financial regulatory agency. One option would be to transfer oversight responsibilities for Fannie Mae and Freddie Mac to the Finance Board. However, the current structure of the Finance Board poses a special problem, since it is required by statute to appoint members to the twelve FHLBs' boards and otherwise become involved in their business (see GAO 1998a). Such involvement (and/or history of such involvement) may, in turn, be viewed as compromising the Finance Board's "regulatory independence" in the sense that it does not have an "arms length" relationship with its regulated entities. Another option, which wouldn't suffer from the same perceived lack of "regulatory independence," would be to merge GSE oversight into an existing independent financial regulatory agency, like the Federal Reserve or FDIC. While little of the current discussion has focused on these options, Carnell (2001a) raises several policy concerns with respect to merging GSE oversight into the Federal Reserve.

So, should a housing GSE safety and soundness regulator be located within an executive branch or organized as an independent agency? The important trade-offs relate to the desired levels of "political independence," "regulatory independence," and "prominence in government." The level of regulatory independence is largely determined by the set of regulated institutions (i.e., how many are there, and how diverse are their interests) and the scope of the regulatory body's mission (i.e., is it solely a regulator). Thus, there would not appear to be any inherent advantage related to the location of the regulator. However, political independence and prominence do come into play.

The primary argument for an independent agency is that it buffers the agency from political pressures. While this may be true with respect to the direct pressures of a presidential administration,[36] such independence surely does not buffer the agency from other political influences;[37] and, more important, this independence also removes the agency from the direct line of political responsibility.[38] Independent agencies, by and large, are also less prominent in government. Unless they are involved in a high profile issue (e.g., the current corporate governance issues that have embroiled the SEC), the independent commissions and boards are often less well known and understood than an executive branch cabinet department, whose secretary always carries the authority of the presidential administration behind him or her.

On balance, it would seem that locating a new housing GSE regulator within the executive branch would generally be preferable to an "independent agency" structure, although a prominent existing independent agency would also be an attractive option. Further, since the primary regulatory function concerns safety and soundness, that location should be in the Treasury. The Treasury possesses substantial expertise in this area and would bear the executive branch responsibility if the federal government ever decided that it must assist a financially troubled GSE. The structure that has developed with respect to the OCC and the OTS – administratively lodged within the Treasury, so that the Treasury can bring its influence to bear and perceives itself to be responsible for the agencies – seems like a sensible melding of the principles of political responsibility while retaining some notions of political independence. The location of the GSEs'

[36] It is not surprising that members of Congress, and especially those who are affiliated with the party that is not in presidential power, are usually those who raise the most concerns about buffering an agency from the political pressures of a presidential administration.

[37] Indeed, one could argue -- contrary to the claim that independence reduces political pressures – that the support of a cabinet secretary could reduce the pressures on an agency that is housed within an executive branch.

[38] Arguably, the extent of the savings and loan debacle was exacerbated by the location of the S&L's regulator and insurer (the FHLBB) as an independent agency that was not directly part of the executive branch. This location outside the executive branch made it easier for the Reagan Administration to accede to the Congress's willingness to ignore the growing problems of the thrift industry and its insurance fund for most of the 1980s. See White (1991).

"mission" regulatory oversight appears to be a less crucial issue, so long as the new Treasury-based regulator retains a say in mission designation (see the discussion below).

2. Agency Funding.

As noted above, OFHEO's assessments are currently subject to the annual congressional appropriations process; and the regulator has long argued that this process hindered its ability to conduct effective long-term planning and general resource flexibility.

All five legislative proposals introduced in 2003 authorized the director of the new entity to collect annual assessments, although four (H.R. 2575, H.R. 2803, S. 1508, and S. 1656) maintain the requirement that the monies be placed in a fund at the Treasury.[39] Analysis provided in Nott and Jickling (2003) suggests that the result of this requirement is that the new office actually wouldn't be removed from the appropriations process.[40] By contrast, according to the same study, the legislative language found in the manager's amendment is similar to other bank regulators and would completely remove the new regulator from the appropriations process. Speaking for the Bush Administration, Treasury Secretary Snow argued that the new agency should be adequately funded by assessments on the regulated entities (e.g., Snow 2003a). However, the agency budget and fee assessments should be subject to review by the

---

[39] According to Nott and Jickling (2003) there were also differences among the bills in terms of what the appropriations could cover: "all reasonable costs and expenses of the office" (House manager's amendment, S. 1508, and S. 1656), or costs of the director "with respect to regulation and supervision" (H.R. 2575, H.R. 2803). The latter language could, in theory, expose the regulator to regular challenges from the enterprises about the appropriateness of the assessments. Moreover, with the exception of the House Financial Services manager's amendment, the bills do not address the regulator's funding requirements during a crisis. In general, regulators have found it important to maintain working capital to carry out elevated supervision in a crisis, above and beyond normal costs. For example, Congress authorized the OTS to maintain a working capital fund for emergency circumstances that allows the agency to collect fees and assessments in excess of actual expenses to help maintain such a fund. The manager's amendment authorizes the GSE regulator to maintain a working capital fund in the "amount the Director deems necessary …"

[40] Nott and Jickling (2003) point out that the Constitution notes that no monies can be drawn from the Treasury except by appropriation. The effect of this provision, the authors contend, is to retain an appropriations requirement, which allows appropriations committees to cap or otherwise restrict the use of funds by an agency.

Administration to avoid any long-term temptation to "gold-plate" agency operations and to ensure the appropriate allocation of resources among the agency's responsibilities.

Previous analysis by the GAO (1997a) and Carnell (2003) concludes that funding for housing GSE regulation should come from the regulated entities and outside of the appropriations process. The primary argument in favor of directly assessing the regulated for the costs of supervision is that it may improve the stability of funding by keeping an agency away from the political exigencies that could accompany explicit annual budgetary appropriations decisions by the Congress. This may be particularly important for a regulator that focuses on only a handful of large and politically powerful entities, like the housing GSEs. Indeed, all other U.S. financial regulators are funded outside of the appropriations process.

However, without some countervailing force, a regulatory agency with levying authority may have an incentive to ratchet fees upward annually. In the case of depository institutions, charter competition provides some countervailing power against such regulatory behavior because these institutions may switch charters if they feel that they are being "overcharged" for their supervision. The housing GSEs, as Congressionally chartered entities, do not have this option. Another drawback to assessments on the regulated entities is that shrinkage in the assessed base would reduce the regulator's funding even if the regulator's responsibilities had not changed.

The argument in favor of immersing a regulatory agency in the annual appropriations process (in which its budget would come from general tax revenues rather than specific assessments on its regulated entities) would be that the regulatory agencies are little different from the other areas and functions of the federal government and that the democratic process (which includes budgetary appropriations), for better or worse, inevitably (and properly) reflects political pressures from the parties who are involved. Indeed, one could argue that the current procedure that applies to OFHEO -- whereby that agency's budget is subject to the annual appropriations process, but then the revenue bill is sent to Fannie Mae and Freddie Mac for payment – may be the worst of all possible arrangements, since it intensifies the enterprises' incentives to lobby in favor of smaller budgets for the safety-and-soundness regulator.

3. All Housing GSEs?

The Bush Administration and some members of Congress have expressed support for combining the safety-and-soundness supervision for all of the housing GSEs into a single agency. Among the regulated, however, Fannie Mae, Freddie Mac, and some of the FHLBs oppose it. As a result, only one of the legislative proposals (H.R. 2803) would consolidate safety and soundness supervisory authority for all three enterprises.

Although Fannie Mae and Freddie Mac generally operate differently from the FHLBs, the risks they manage (e.g., interest rate risk associated with holding long-term, fixed rate mortgage-related assets) and the missions that they fulfill are similar. The GAO (1997a) and Carnell (2003) outline four advantages to combining housing GSE oversight. The first is that a single regulator would likely have more independence from the firms it regulates because of the different business models and interests, which, in turn, could create a "healthy tension" that serves to reduce the probability of regulatory capture. The second is that a combined regulator would be larger and "more prominent in government" with such stature helping to attract and retain qualified staff. The third is that there could potentially be some economies of scale and scope in joint supervision. Finally, a single regulator would help ensure consistent regulatory treatment, which could foster more competitive equity across housing GSEs to the potential benefit of mortgage borrowers.

Alternatively, multiple regulators offer varying forums within which new ideas, new institutional forms, and new regulatory procedures can be developed and implemented.[41] This concept, which is consistent with the "dual banking system" of federal and state chartering and regulation, is generally perceived to be a net benefit.[42] However, one mitigating factor in the context of GSE regulation is that, unlike in banking, the regulated cannot select their supervisory authority. As a result, "regulatory competition" in this context may only serve to tilt the competitive balance toward one set of institutions without the other set's being able to take advantage of any regulatory changes.

B. Institutional Authorities

There appears to be a consensus that, so long as the federal implied guarantee remains, there should be a strong safety-and-soundness system applied to the housing GSEs.[43] Further, as noted by White (2003b), the experience of the past two to three decades of depository institution regulation has yielded the clear lesson that an effective safety-and-soundness regime includes (among other things) both minimum capital requirements and activities limitations. Minimum capital requirements should: 1) be gauged to the risks that are inherent in the institution's assets and activities (i.e., risk-based capital); 2) be measured on a market value accounting (mark-to-market) basis; 3) be a basis for supervisory actions, such as the appointment of a conservator or a receiver

---

[41] As a concrete example, consider the FHLBs' development of mortgage purchase programs in the late 1990s that compete with Fannie Mae and Freddie Mac (Frame 2003). If the FHLBs had been under OFHEO's regulatory purview, rather than the Finance Board's, approval might well not have been forthcoming.

[42] See, for example, Scott (1977) and Rosen (2003). For a similar argument that applies to securities regulation, see Gramm and Gray (1994).

[43] As we noted above, it is possible that the presence of strong safety-and-soundness regulation may enhance the financial markets' perception of an implied guarantee. Until the Treasury is ready explicitly to renounce the guarantee, however, a strong safety-and-soundness regime seems preferable to a weak or non-existent one.

(as well as interim actions, such as restrictions on growth or capital distributions); and 4) include a tranche of subordinated debt. Activities limitations are justified primarily when the regulator feels that it cannot sensibly set capital requirements and judge managerial competence with respect to the activities in question.

In addition to disputes over the location, funding, and structure of a new housing GSE regulatory structure, debate persists over the proposed agency's institutional authorities. The main areas of contention involve the responsibility for approving new activities proposed by the housing GSEs, whether the regulator should have discretion in setting regulatory capital requirements, and the availability of certain enforcement authorities – particularly receivership authority.

1. New Activities Approval.

HUD currently has oversight responsibilities for the housing mission of the enterprises, which to this point has included new program authority and compliance with affordable housing goals. Under current law, HUD is required to approve any new mortgage program[44] that Fannie Mae or Freddie Mac proposes unless the department determines that it either would result in a charter violation or is not in the public interest.[45] HUD must approve or reject such proposals within 45 days of submission, with one 15-day extension allowed if additional information is required, or the proposals are automatically approved. In short, the burden is on HUD to determine quickly whether there are sufficient reasons to keep an enterprise from proceeding with any new initiative.

[44] A "new mortgage program" is defined as one that is "significantly different from programs that have been approved, or that represent an expansion (in terms of the dollar volume or number of mortgages or securities involved) of programs previously approved."

[45] A third criterion is if OFHEO determines that the program would risk significant deterioration of the financial condition of the enterprise. However, this provision expired twelve months after OFHEO's risk-based capital rule became effective.

GAO (1998b) concluded that, at that time, HUD had not fully implemented a process under its general regulatory and new mortgage program approval authorities to ensure that Fannie Mae's and Freddie Mac's activities were consistent with their housing missions. The report further questioned whether HUD had the capacity to evaluate sophisticated financial products that may be associated with new mortgage program applications. While the number of new mortgage program approvals has been modest (there were three between 1995-2000), HUD has elected to not review major new initiatives such as entry into the subprime market and the implementation of automated underwriting systems (Fishbein, 2003).[46]

In the recent legislative debate, there has been interest in moving the new program authority function from HUD to the new safety and soundness regulator and/or expanding the regulatory scope for limiting new activities.[47] The Bush Administration has supported such provisions on the grounds that new program authority is closely related to safety and soundness and that other financial regulators have this authority (Snow 2003b; Mankiw 2003).[48] The Administration further supports giving the new regulator the authority to review "new activities" (and not just new programs) at the housing GSEs.

Fannie Mae and Freddie Mac as well as other interested parties have expressed a great deal of concern about moving the new program authority to the safety-and-soundness regulator as well as expanding the scope for imposing limitations. This concern has arisen for two reasons. First,

[46] In addition, there is no public information on new programs that may have been informally proposed but were then informally vetoed and never attracted public attention.

[47] Under three of the bills, new program authority would be transferred to the new office: two bills (H.R. 2803 and S. 1508) do this outright, while another does this with a provision to consult with the Secretary of HUD (S. 1656). Another bill (H.R. 2575) proposes to maintain authority with the Secretary of HUD, but expand the authority to all new "activities" instead of just "programs" and removes the current 45-day time limit that HUD must meet in order to avoid automatic approval of a proposed new program. The House Financial Services manager's amendment retains prior approval authority with HUD, but expands the HUD Secretary's authority to both new and ongoing programs. All five bills retain the HUD Secretary's authority for affordable housing goals.

[48] For example, the OCC and OTS act as safety-and-soundness regulators for national banks and thrifts, respectively, but also enforce mission requirements like the Community Reinvestment Act.

moving new program authority away from HUD is viewed as a potential threat to housing as a public policy priority. Second, expanding the scope for imposing limitations is viewed as unnecessary micro-management that could stifle mortgage market innovation.[49]

Both GAO (1997a) and Carnell (2003) advocate combining the safety-and-soundness and mission regulation of Fannie Mae and Freddie Mac and then conjoining them with the responsibilities of the Finance Board, which already oversees all aspects of FHLB regulation. Their reasoning is three-fold. First, it would promote accountability by both the regulator and the housing GSEs, since divided responsibilities create the potential for the regulated entities to pit the regulators against each other.[50] Second, joint responsibility would simplify compliance on the part of the housing GSEs. Finally, insofar as GSE policy must account for both mission and safety and soundness, giving one agency both responsibilities would promote better-informed decision-making (Carnell 2003).

Without endorsing a particular approach to mission regulation, we see two primary issues here. The first is the interests of the safety-and-soundness regulator in limiting activities for which capital standards and managerial competence standards cannot be set.[51] This argues strongly for the safety-and-soundness regulator's having a say in any new programs or activities. The second focuses on efficiency considerations related to so-called "mission creep," or the tendency of a GSE to want to grow in size by taking on new activities. Specifically, one would want to examine

[49] For example, Raines (2003) opines that: "H.R. 2575 would stifle innovation in the mortgage market by requiring prior approval for any new 'program, activity, business process, or investment that directly or indirectly provides financing or other services to conventional mortgages.' It would replace the current standard, which is to review any program that is 'significantly different' from a program already in place in 1992, with a standard that sanctions a virtually limitless scope of review. The provision would also allow HUD to reject new programs even if they comply with our charter and are in the public interest."

[50] This is frequently described as encouraging a regulatory "race to the bottom". On the other hand, to the extent that regulations are needlessly restrictive, such regulatory competition can be beneficial.

[51] See the discussion by White (1996), Shull and White (1998a, 1998b), and White (2003b) on this point, where the concept of "examinability and supervisability" is introduced.

carefully whether the expansion into an activity is due to the inherent efficiency of the GSEs' operations, or whether it simply represents an extension or leveraging of the GSEs' special advantages.[52]

2. Capital Standards.

Fannie Mae and Freddie Mac are currently subject to three statutory capital standards. First, the *minimum capital standard* requires each enterprise to hold total capital equal to at least the sum of 2.50 percent of on-balance sheet assets, plus 0.45 percent of off-balance sheet guarantees. Second, the *critical capital standard* requires each enterprise to hold total capital equal to at least the sum of 1.25 percent of on-balance sheet assets, plus 0.25 percent of off-balance sheet guarantees.[53] Finally, the *risk-based capital standard* requires each enterprise to hold enough capital to cover credit risk and interest-rate risk plus another 30 percent of this sum for management and operations risk. The risk-based standard is based an OFHEO-developed stress test model, the broad parameters of which (including the 30 percent add-on) are dictated by statute.

As noted above, the Bush Administration supports giving the new safety-and-soundness regulator the discretion to set minimum and risk-based capital levels, rather than having them set in statute (Snow 2003b; Mankiw 2003). Indeed, Snow (2003b) notes that "broad authority over capital standards and the ability to change them as appropriate are of vital importance to a credible, world-class regulator." And this would be consistent with current practice for banking (Carnell,

[52] To the extent that effective capital requirements (discussed below) bring the GSEs' actual capital ratings closer to the ratings that are implied by their borrowing rates, these efficiency concerns should diminish. But they will not entirely disappear, since the GSEs get other benefits besides unduly favorable borrowing rates, and corporative imperatives for growth are generally quite strong.

[53] This the level of capital below which OFHEO is generally required to appoint a conservator.

2001a). By contrast, Raines (2003), speaking on behalf of Fannie Mae, believes that its minimum capital requirement should remain set in statute and at current levels.

Two of the proposed bills (H.R. 2575 and S. 1508) allow for greater regulatory discretion regarding capital by permitting the director of the new office to: 1) apply alternative economic scenarios in the risk-based capital stress test, including assumptions pertaining to interest rates, home prices, and new business; and 2) increase the required minimum and critical capital levels for the enterprises by regulation or order.[54] H.R. 2803, on the other hand, offers no provision to amend the capital standard requirements currently set in statute, while S. 1656 mandates that the director review the adequacy of current risk-based capital standards and, if necessary, make recommendations to Congress for changes in the statutory levels.

As a general matter, the Congress establishes broad policy goals for regulatory agencies and then directs the agencies to set the specific details of regulatory standards. An important reason for this is that agency personnel are better versed in the minutia of specific issues and are better suited to adapt regulatory standards as theory and practice evolve. The establishment of prudential capital standards would seem to fit this mold. And as noted above, federal bank regulators already have this important authority.

3. Enforcement Authorities.

Financial regulators are responsible for ensuring that the institutions they supervise operate in a safe and sound fashion. To that end, each regulator has an array of enforcement tools at its disposal, although statutory differences may exist across regulators. GAO (2001) provides a side-by-side comparison of the "prompt corrective action" (PCA) provisions and

[54] S. 1508 also requires that the risk-based capital standard be similar to those used by federal banking regulators.

general enforcement authorities of U.S. federal bank regulators,[55] OFHEO, and the Finance Board.

Bank regulators and OFHEO have statutory capital-based actions and restrictions, which are commonly referred to as PCA provisions.[56] The Finance Board, on the other hand, does not have such provisions, although it may enforce similar measures on its own accord.

Although the PCA classifications triggering action are the same for bank regulators and OFHEO, the capital requirements underlying these classifications are different. According to GAO (2001), OFHEO's PCA scheme: may provide for regulatory action at a lower level of capital classification, has fewer required actions imposed, provides the regulator with more discretion in determining specific actions to take, and has more notice and comment periods. Overall, Carnell (2001a) argues that the PCA rules governing Fannie Mae and Freddie Mac are conspicuously weaker than those governing FDIC-insured depository institutions.[57]

The range of enforcement actions available to OFHEO, in turn, is largely dependent on the capital classification of Fannie Mae or Freddie Mac.[58] If an enterprise is *adequately capitalized*, there are no prescribed supervisory actions.[59] An *undercapitalized* enterprise must

---

[55] These are the OCC, OTS, Federal Reserve, and the FDIC.

[56] PCA rules applying to Fannie Mae and Freddie Mac can be found at 12 U.S.C. 4614-4619, 4622. Those for FDIC-insured depository institutions can similarly be found at 12 U.S.C. 1831o.

[57] Carnell (2001a) illustrates this in the following way. An undercapitalized bank cannot increase its total assets unless (1) the bank has an acceptable capital restoration plan, (2) the asset growth comports with the plan, and 3) the bank's capital ratio increases at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time. However, no statute bars Fannie Mae and Freddie Mac from continuing to grow while undercapitalized, even if they have no capital restoration plan or if the growth conflicts with such a plan. The PCA statute authorizes growth restrictions only against a significantly or critically undercapitalized GSE and makes such sanctions purely discretionary.

[58] Four classifications exist: 1) *adequately capitalized*, if both the risk-based and minimum capital levels are met; 2) *undercapitalized*, if the minimum level is met, but not the risk-based, 3) *significantly undercapitalized*, if only the critical capital level is met, and 4) *critically undercapitalized*, if none of the levels is met by an enterprise.

[59] However, cease and desist orders may be still issued for conduct that seriously threatens the enterprise's capital base.

have a capital restoration plan approved by OFHEO and may not make any capital distributions that could result in further slippage.[60] For a *significantly undercapitalized* enterprise, a capital restoration plan and any capital distributions must be approved. In this category, restrictions may be placed on growth and certain activities; new capital may be required; and, should the capital restoration plan not be approved or followed, OFHEO is authorized to appoint a conservator to take over operations. For a *critically undercapitalized* enterprise, OFHEO is required to appoint a conservator unless there is a finding that there would be an adverse impact on financial markets and/or that such an appointment is not in the public interest.

GAO (2001) found that the similar enforcement authorities were available to federal bank regulators, OFHEO, and the Finance Board to address significant safety and soundness concerns (e.g., the ability to issue cease and desist orders or to impose civil money penalties). However, the study highlighted important differences between the bank regulators and OFHEO regarding: 1) certain aspects of their cease and desist authorities; 2) removal and prohibition authorities applicable to officers and directors; and 3) receivership and litigation authorities. The remainder of this section focuses on receivership authorities, the enforcement power garnering the most attention in the current debate.

GAO (2001) reminds us that, with respect to undercapitalized institutions, bank regulators must appoint a receiver, appoint a conservator (with the FDIC's concurrence), or take other action (with FDIC concurrence) that best serves PCA. Indeed, Carnell (2001a) argues that bank receivership laws facilitate a relatively rapid, efficient, and orderly resolution of claims against a failed or failing bank. Specifically, as receiver, the FDIC is empowered to operate and/or liquidate the bank; and if the bank is insolvent, its shareholders lose their ownership interest and creditors

---

[60] If no plan is approved or an approved plan is not complied with, OFHEO is authorized to classify an enterprise downward.

may incur losses. A conservator, by contrast, is appointed to "conserve" rather than "dispose of" the assets.

OFHEO does have the authority to appoint a conservator for a significantly undercapitalized enterprise and (after notice) must generally appoint one for a critically undercapitalized enterprise. However, unlike the bank regulators, OFHEO lacks the authority to place an enterprise into receivership. The Finance Board, by contrast, does have the statutory authority to liquidate or reorganize an FHLB whenever the Finance Board finds that the efficient and economical accomplishment of the purposes of the Federal Home Loan Bank Act will be aided by such action.

The Bush Administration supports well-defined receivership authorities for housing GSE regulators (Snow 2003b; Mankiw 2003). On the legislative front, H.R. 2575 (as well as the House Financial Services manager's amendment) would authorize the regulator to appoint a receiver to liquidate or wind up the affairs of a critically undercapitalized enterprise. Fannie Mae (2003) argues that H.R. 2575, among other things, would impose a harsh enforcement and PCA regime on the housing GSEs and would take away from Congress the ultimate ability to dissolve the GSE. Nevertheless, it seems straightforward that a "world-class financial regulator" should have receivership powers. That said, because Fannie Mae's and Freddie Mac's charters were created by Congress (rather than by the regulatory agency), the revocation of the charter through a receivership may pose additional legal questions.

V. Conclusions

The housing GSEs are large, highly leveraged financial institutions that receive several economically significant benefits. On the heels of a massive accounting restatement by Freddie Mac in 2003, a reorganization of the housing GSEs' regulatory structure is an active legislative topic. While privatization may well be the best solution with regard to the dilemmas of regulating these enterprises (e.g., White 2003a), it is unrealistic to believe that privatization is likely to arrive anytime soon. As a result, an effective regulatory regime – especially with respect to safety-and-soundness – is essential.

In this paper we have reviewed the recent controversies concerning GSE regulation, including the issues of institutional design and authorities. With respect to institutional design, we have tried to outline the inherent trade-offs and appreciate that there may not be a clearly dominant approach. However, previous analysis provided by GAO (1997a) and Carnell (2003) does reach some conclusions that merit serious consideration. As for institutional authorities, we concur with remarks made by Treasury Secretary Snow that the new regulatory agency's powers should be "comparable in scope and force to those of other world-class financial supervisors." As a result, we think that the regulator should have: 1) at least some responsibility for the approval of new programs and other activities; 2) the discretion to set both minimum and risk-based capital requirements; 3) receivership authority; and 4) other enforcement authorities comparable to the federal banking agencies.

As of year-end 2003 the Congress had passed no legislation with respect to the GSEs' regulatory structure, but these legislative proposals remain alive in 2004. How the Congress balances its focus on housing with the safety-and-soundness concerns at the GSEs bears close attention.

References

Baker-Botts L.L.P. 2003. Report to the board of directors of the Federal Home Loan Mortgage Corporation: Internal investigation of certain accounting matters, December 10, 2002 – July 21, 2003. Available at: www.freddiemac.com/news/board_report.

Canfield & Associates, Inc. 2002a. OFHEO says it will increase its oversight of Fannie's portfolio and its duration gap. *The GSE Report*, September 27: 11. Available at: www.gsereport.com.

Canfield & Associates, Inc. 2002b. Congressman Baker criticizes OFHEO's concerns about Fannie as 'overdue' – asks OFHEO for its weekly status reports on Fannie. *The GSE Report*, September 27: 12. Available at: www.gsereport.com.

Carnell, Richard. 2001a. Reforming the regulation of Fannie Mae and Freddie Mac. Statement before the subcommittee on capital markets, insurance, and government sponsored enterprises, Committee on financial services, U.S. House of Representatives. (July 11). Available at: www.financialservices.house.gov/media/pdf/071101rc.pdf.

Carnell, Richard. 2001b. Federal deposit insurance versus federal sponsorship of Fannie Mae and Freddie Mac: The structure of subsidy. In *Proceedings: Conference on Bank Structure and Competition*. Chicago: Federal Reserve Bank of Chicago.

Carnell, Richard. 2003. Improving the regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. Statement prepared for the committee on banking, housing, and urban affairs, U.S. Senate (November 13). This hearing was postponed, but a copy of the prepared testimony is available by e-mailing: rcarnell@law.fordham.edu.

Cohen, Hugh. 1993. Beyond duration: Measuring interest rate exposure. Federal Reserve Bank of Atlanta *Economic Review* 78 (March/April): 23-31.

Craig, Ben R. and James B. Thomson. 2003. Federal Home Loan Bank lending to community banks: Are targeted subsidies desirable? *Journal of Financial Services Research* 23 (February): 5-28.

Fannie Mae. 2002a. Fannie Mae comments on duration gap and OFHEO letter. Available at: www.fanniemae.com/ir/issues/financial/091802.jhtml?s=Current+Issues.

Fannie Mae, 2001. Setting the record straight: An analysis of CBO's 2001 report on Fannie Mae and Freddie Mac. (May 23). Available at: www.fanniemae.com/global/pdf/ir/issues/fmcbo.pdf.

Fishbein, Allen. 2003. Testimony before the Committee on Financial Services, U.S. House of Representatives. (September 25). Available at: www.financialservices.house.gov/media/pdf/092503af2.pdf

Frame, W. Scott. 2003. Federal Home Loan Bank mortgage purchases: Implications for mortgage markets. Federal Reserve Bank of Atlanta *Economic Review* 88 (third quarter): 17-31.

Frame, W. Scott and Larry Wall. 2002. Fannie Mae's and Freddie Mac's voluntary initiatives: Lessons from banking. Federal Reserve Bank of Atlanta *Economic Review* 87 (first quarter): 45-59.

Freddie Mac. 2003. Supplement to information statement dated March 29, 2002 (Released September 25). Available at: www.freddiemac.com/investors/infostat/.

Freddie Mac, 2001. Detailed analysis of the 2001 CBO report 'federal subsidies and the housing GSEs.' Appendix to the written statement of Mitchell Delk before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises (Committee on Financial Services), July 11. Available at: www.freddiemac.com/speeches/md071101.htm.

Gould, George. 2003. Statement before committee on financial services, U.S. House of Representatives. (September 25). Available at: http://financialservices.house.gov/media/pdf/092503gg.pdf

Gramm, Wendy L. and Gerald D. Gray. 1994. Scams, scoundrels, and scapegoats: A taxonomy of CEA regulation over derivative instruments. *Journal of Derivatives*, 1: 6-24.

Haviv, Julie. 2002. Fannie Mae narrows duration gap – Mortgage concern achieves better match of assets and liabilities it owns. *Wall Street Journal*, November 18: C11.

Inside Mortgage Finance. 2003. Movement on GSE reform legislation stalls as opposition mounts to compromise bill. (October 10): 3-5.

Jaffee, Dwight. 2003. The interest rate risk of Fannie Mae and Freddie Mac. *Journal of Financial Services Research*, 24(1): 5-29.

Kane, Edward, and Chester Foster. 1986. Valuing conjectural government guarantees of FNMA liabilities. In *Proceedings: Conference on Bank Structure and Competition*. Chicago: Federal Reserve Bank of Chicago.

Mankiw, N. Gregory. 2003. Remarks at the Conference of State Banking Supervisors State Banking Summit and Leadership Conference. (November 6). Available at: www.whitehouse.gov/cea/gsemankiw_speech_nov_6_2003.pdf.

Nott, Loretta and Mark Jickling. 2003. Improving the effectiveness of GSE oversight: Legislative proposals. CRS Report for Congress (October 8, 2003). Washington, DC: Congressional Research Service (CRS).

Pearce, James and James Miller. 2001. Response to CBO's draft report: Federal subsidies and housing GSEs. Freddie Mac Press Release, May 18. Available at: www.freddiemac.com/news/analysis/gse_benefits2.htm.

Raines, Franklin. 2003. Statement before the committee on financial services, U.S. House of Representatives. (September 25). Available at: http://financialservices.house.gov/media/pdf/092503fr.pdf.

Rosen, Richard J. 2003. Is three a crowd? Competition among regulators in banking. *Journal of Money, Credit and Banking* 35 (December): 967-998.

Saunders, Anthony. 2000. *Financial Institutions Management*. Irwin/McGraw-Hill.

Scott, Kenneth. 1977. The dual banking system: A model of competition in regulation. *Stanford Law Review* 30 (November): 1-50.

Shadow Financial Regulatory Committee. 2002. Fannie Mae's duration gap. Statement 181 (September 23).

Shull, Bernard E. and Lawrence J. White. 1998a. The right corporate structure for expanded bank activities. *Journal of Banking Law*, 115 (May): 446-476.

Shull, Bernard E. and Lawrence J. White. 1998b. Of firewalls and subsidiaries: The right stuff for expanded bank activities. In Federal Reserve Bank of Chicago, *Payment Systems in the Global Economy: Risks and Opportunities*, 34th Annual Conference on Bank Structure and Competition, May.

Snow, John. 2003a. Testimony before the Committee on Financial Services, U.S. House of Representatives. (September 10). Available at: http://www.treas.gov/press/releases/js716.htm.

Snow, John. 2003b. Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs. (October 16). Available at: http://www.treas.gov/press/releases/js905.htm.

Toevs, Alden 2001. Federal subsidies and the government-sponsored enterprises: An analysis of the CBO study. *Bank Accounting and Financ*e 15(1): 24-31.

U.S. Congressional Budget Office (CBO). 2001. *Federal Subsidies and the Housing GSEs*. Washington, D.C.: CBO.

U.S. Office of Federal Housing Oversight (OFHEO). 2003. *Report to Congress*. Washington, D.C.: OFHEO.

U.S. General Accounting Office (GAO). 1990. *Government-Sponsored Enterprises: The Government's Exposure to Risks*. Washington, D.C.: GAO.

U.S. General Accounting Office (GAO). 1997a. *Housing Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator*. Washington, D.C.: GAO.

U.S. General Accounting Office (GAO). 1997b. *Federal Housing Enterprises: OFHEO Faces Challenges in Implementing a Comprehensive Oversight Program*. Washington, D.C.: GAO.

U.S. General Accounting Office (GAO). 1998a. *Federal Housing Finance Board: Action's Needed to Improve Regulatory Oversight*. Washington, D.C.: GAO.

U.S. General Accounting Office (GAO). 1998b. *Federal Housing Enterprises: HUD's Mission Oversight Needs to be Strengthened*. Washington, D.C.: GAO.

U.S. General Accounting Office (GAO). 2001. *Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities*. Washington, D.C.: GAO.

White, Lawrence J. 1991. *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. New York: Oxford University Press.

White, Lawrence J. 1996. The proper structure of universal banking: "Examinability and supervisability" are the key words. In A. Saunders and I. Walter, eds., *Financial System Design: The Case for Universal Banking*. Irwin: 682-695.

White, Lawrence J. 2003a. Focusing on Fannie and Freddie: The dilemmas of reforming housing finance. *Journal of Financial Services Research*, 23 (February): 43-58.

White, Lawrence J. 2003b. What constitutes appropriate disclosure for a financial conglomerate? In Richard Herring and Robert W. Litan, eds., *Brookings-Wharton Papers on Financial Services 2003* Brookings: 245-272.

Table 1: Duration Gap Estimates for Fannie Mae and Freddie Mac
March 31, 2001 – October 31, 2003

	Duration Gap (Months)	
Month	Fannie Mae	Freddie Mac
March 2001	1	Not available.
April 2001	7	Not available.
May 2001	7	Not available.
June 2001	5	Not available.
July 2001	0	Not available.
August 2001	-1	0
September 2001	-1	-1
October 2001	-10	0
November 2001	3	1
December 2001	5	1
January 2002	2	0
February 2002	-2	0
March 2002	5	1
April 2002	0	-1
May 2002	-1	-1
June 2002	-4	0
July 2002	-9	0
August 2002	-14	0
September 2002	-10	-1
October 2002	-6	-1
November 2002	2	0
December 2002	5	0
January 2003	-3	0
February 2003	-5	-1
March 2003	-2	-1
April 2003	-2	0
May 2003	-5	0
June 2003	-1	0
July 2003	6	1
August 2003	4	0
September 2003	1	-1